

Sellers of special order machines are considered to be engaged primarily in a service occupation, rather than being engaged in the business of selling tangible personal property, if the test set out in 86 Ill. Adm. Code 130.2115(b)(1) is met. See 86 Ill. Adm. Code 130.2115. (This is a GIL).

March 23, 2001

Dear Xxxxx:

This letter is in response to your letter dated January 18, 2001. The nature of your letter and the information you have provided require that we respond with a General Information Letter, which is designed to provide general information, is not a statement of Department policy and is not binding on the Department. See 2 Ill. Adm. Code 1200.120 subsections (b) and (c), which can be found on the Department's Internet website at <http://www.revenue.state.il.us/legalinformation/regs/part1200>.

In your letter, you have stated and made inquiry as follows:

I am writing to you on behalf of our client (the Company) which is requesting a General Information Letter (GIL), pursuant to 2 Ill. Admin. Code Sec. 1200.120. The GIL should address the sales and use taxability of a material-handling conveyor system (the conveyor) which the Company has purchased. GILs respond to inquiries made by taxpayers or their representatives. We understand that GILs discuss tax principles or applications and are not binding on the Illinois Department of Revenue (the IDOR).

### **FACTS**

The Company owns retail stores throughout Illinois. It supplies the stores from a distribution warehouse located in the state. To streamline inventory operations and achieve cost efficiencies, the Company contracted with another business (the Seller) to build and install a specially-designed conveyor for use at the warehouse. The Company uses the conveyor to account for and hold inventory purchased from suppliers and to pick and ship it to retail stores when needed.

The Company in considering design requirements had to have the conveyor engineered to conform to the particular size and shape (i.e., the floor plan) of the existing warehousing facility. (The warehouse is composed of an older section and a new addition.) While requiring that the conveyor meet current warehousing dimensions, the Company also intended that the conveyor accommodate future expansions, variances in stock sizes and types, and technological changes necessitating its modernization.

To meet the aforementioned requirements, the Company chose the Seller over other competitors for its business. This is because of the Seller's reputation in its industry. The Seller's website and its other promotional materials indicate that it considers itself

an industry leader in engineering, designing, and manufacturing material-handling systems and in developing products for meeting its customers' specific application requirements.<sup>1</sup>

The Seller's 147-page Sales Proposal (and design plan) evidences that it contributed substantially to the detailed configuration of the conveyor. The Proposal specifically addresses how the Seller would execute the unique mechanical "design of nonstandard equipment components and the integration of standard and nonstandard equipment into an operational [conveyor] system." Proposal from Seller, p. 2. The document also explains how the Seller's engineering (and computer automation) skills would meet the challenges posed by the precise space and movement limitations at the warehouse. (Exhibit A, attached herein, includes a portion of the Sales Proposal summarizing the design plan.)

The design, engineering, fabrication, and installation of the conveyor required that the Seller draw up 65 blueprints outlining its composite layout. The blueprints illustrate the exact nature of the conveyor's floor and ceiling supports-including their angles and elevations<and the precise placements of its sensors, scanners, sorters, slider beds, chutes, rollers, and spans of treads, all in conformity with the unique design elements required. Indeed, the blueprints convey many special details of the conveyor needed to conform to the peculiar floor plan and dimensions of the warehouse for which it was created<namely, the speed and lengths of its belts at specific points (including floors, ceilings, and walls), turns, crossovers, curves, ascents and descents, and the placement of feeder and takeaway lines. (Exhibit B, attached herein, includes three of the 65 blueprints drawn.)

The costs of design and engineering services, fabrication labor, and installation represent approximately 60-70 percent of the conveyor's selling price to the Company, while direct material costs represent approximately 30-40 percent<sup>2</sup>. It is possible that the conveyor could be dismantled and erected at another warehousing site. Practically speaking, however, it would be prohibitively expensive to do so<in other words, equivalent to purchasing a new conveyor<since another set up would entail the redesign and reengineering of the conveyor, plus the reintroduction of nonstandardized parts necessary for conforming the conveyor to the spatial requirements of another location.

## **ISSUE**

How should the conveyor be treated for Illinois sales and use tax purposes?

## **LAW**

Illinois imposes a retailers' Occupation Tax (the ROT) on persons engaged in selling within the state tangible personal property at retail..<sup>35 ILCS 120/2</sup>. Illinois also imposes a Service Occupation Tax (the SOT) on servicepersons who transfer tangible personal property as an incident to making a sale of service in the state. <sup>35 ILCS 115/3</sup>. A Service Use Tax (the SUT) is imposed on the use of tangible personal property acquired as an incident to the sale of a service in the in the state. <sup>35 ILCS 110/3</sup>. tangible personal property acquired as an incident to the sale of a service in the state. <sup>35 ILCS 110/3</sup>. The SUT complements the SOT. <sup>35 ILCS 110/3-55</sup>. Further, when a serviceperson designs, develops, and produces special-order machinery or equipment,

the SOT applies and is measured by the cost price to the serviceperson of the tangible personal property transferred to the service customer. 35 ILCS 115/3-10. "Cost price" means the consideration which the serviceperson pays to its supplier for the tangible personal property which is transfers to its service customer. 35 ILCS 115/2.

Pursuant to an IDOR regulation, special-order machinery is produced when (1) the purchaser employs the seller specifically for its engineering and design skills to produce a machine to meet the purchaser's particular and unique needs; (2) the machine has use or value only for the specific purpose for which it is produced, and (3) the machine has use or value only to the purchaser. The regulation adds that, in the case of special conveyors, the sale would receive SOT treatment even if a fairly substantial portion of the conveyor were made of standard parts or raw material (such as steel) which can be stocked for sale. 86 Ill. Admin. Code Sec. 130.2115(b) and (c).

Illinois case law addressing conveyors also stipulates three criteria for identifying special-order property subject to tax under the SOT: (1) The seller contributes substantially to the design of the product. (2) The property have use or value only to the purchaser. (In other words, the property has to be produced according to special requirements peculiar to the purchaser and not common to others whose conditions for possible use of the property are reasonably comparable to those of the purchaser.) (3) The equipment only has salvage value to others and therefore is useless to anyone but the customer for who it is produced. Catepillar Tractor Co. v Department of Revenue (Illinois Supreme Court, 1963).

## **ANALYSIS**

The conveyor meets for the following reasons the requirements under Illinois law for designation as special-order property:

- The Company chose the Seller because it is an industry leader in designing and engineering conveyor systems to meet customer's specific application requirements.
- The Seller's 147-page sales proposal/design plan and 65 engineering blueprints demonstrate that the conveyor had to be created to fit the exact and unique specifications of the existing warehouse structure.
- Emphasis on the Seller's design and engineering skills is underscored by the fact that approximately two-thirds of the Seller's production costs were attributable to services<design, engineering, and installation services, and fabrication labor<while only one-third were attributable to direct-material purchases.
- As evidenced by the design plan and accompanying blueprints, the conveyor was especially created only for use at the Company's warehouse in Illinois.
- The conveyor has value only to the Company. It could be dismantled and set up elsewhere, but the costs of doing so would approximate those attached to purchasing a new conveyor.

Thus, applying state law to the facts in the current case, the conveyor should be considered special-order machinery subject to tax under the SOT. Accordingly, the tax should be measured by the cost price to the Seller of the tangible personal property (i.e., the direct materials) which it transferred to the Company.

## **CONTRARY AUTHORITY AND DISCUSSION**

The IDOR might argue that the conveyor is taxable under the ROT, as measured by its full retail selling price, because it is a stock item. In other words, it was created from standard parts which might be disassembled and then reassembled for use at any other warehousing facility.

In response, the following point should be made:

- The conveyor as fabricated and installed can only be used by the Company for the purposes for which it was designed.
- Its deployment at another warehouse would not be cost effective relative to fabricating an entirely new conveyor for the other site.
- An IDOR regulation states that a special conveyor does not lose its otherwise special-order status even though it is built substantially from standard stock parts.

## **CONCLUSION**

The facts of the case support the finding that the Company's purchase of the conveyor should be taxed under the SOT and be measured by the Seller's cost price of the materials transferred to the Company. This conclusion is consistent with state law and IDOR regulations.

We respectfully request that the IDOR send to us on behalf of the Company a GIL addressing the issue presented. Your cooperation is appreciated.

## **DEPARTMENT'S RESPONSE:**

Generally, sellers of machinery to users and consumers incur Retailers' Occupation Tax liability on such sales. However, sellers of special order machines are considered to be engaged primarily in a service occupation, rather than being engaged in the business of selling tangible personal property, if the test set out in 86 Ill. Adm. Code 130.2115(b)(1) is met:

- A) The purchaser employs the seller primarily for his engineering or other scientific skill to design and produce the property on special order for the purchaser and to meet the particular needs of the purchaser;
- B) the property has use or value only for the specific purpose for which it is produced; and
- C) the property has use or value only to the purchaser.

Part (5) of subsection (b) of 86 Ill. Adm. Code 130.2115 states that "[I]n the case of special assemblies such as special conveyors, the sale does not become taxable (if it would otherwise be exempt under this subsection (b)) merely because a fairly substantial portion of the completed product is made of standard parts or of raw material (such as steel) which can be stocked for sale."

In general, a sale of conveyors as described in your letter whereby the seller is hired for its engineering or other scientific skill to design and produce the conveyors and the conveyors have use or value only for the specific purpose for which they are produced (even though a fairly substantial portion of the conveyors are made of standard or stock parts), will be taxed as a sale of service under the Service Occupation Tax Act rather than under the Retailers' Occupation Tax Act. For your

general information, please see 86 Ill. Adm. Code 140.101 regarding sales of service and Service Occupation Tax.

Under the Service Occupation Tax Act, businesses providing services (i.e. servicemen) are taxed on tangible personal property transferred as an incident to sales of service. See 86 Ill. Adm. Code 140.101. The purchase of tangible personal property that is transferred to the service customer may result in either Service Occupation Tax liability or Use Tax liability for the servicemen depending upon which tax base the servicemen choose to calculate their tax liability. The servicemen may calculate their tax base in one of four ways: (1) separately stated selling price of tangible personal property transferred incident to service; (2) 50% of the servicemen's entire bill; (3) Service Occupation Tax on the servicemen's cost price if the servicemen are registered de minimis servicemen; or (4) Use Tax on the servicemen's cost price if the servicemen are de minimis and are not otherwise required to be registered under Section 2a of the Retailers' Occupation Tax Act. However, when a serviceman contracts to design, develop, and produce special order machinery or equipment, the tax imposed by the Service Occupation Tax Act is based on the serviceman's cost price of the tangible personal property transferred incident to the completion of the contract. See 35 ILCS 115/3-10 (1998 State Bar Edition).

I hope this information is helpful. The Department of Revenue maintains a website, which can be accessed at [www.revenue.state.il.us](http://www.revenue.state.il.us). If you have further questions related to the Illinois sales tax laws, please contact the Department's Taxpayer Information Division at (217) 782-3336.

If you are not under audit and you wish to obtain a binding Private Letter Ruling regarding your factual situation, please submit all of the information set out in items 1 through 8 of Section 1200.110(b) described above.

Very truly yours,

Terry D. Charlton  
Associate Counsel

TDC:msk  
Enc.

<sup>1</sup> For example, the Seller's website describes it as the "industry leader in material handling systems engineering, design, and manufacturing." Seller Website, [News](#) p.1. The Seller states on the website that its strengths include a "commitment to solving customers' problems" and the "development of material handling systems that meet customers' specific application requirements." Seller Website, [At a Glance](#), p. 1. The website also lists examples of products "developed in response to the requirements of [its] customers." Seller Website, [Research and Development](#), p. 1.

<sup>2</sup> The 30-40 percent is determined as follows:

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|---|------------------------------|----------------|
| • Total Cost to design, engineer, manufacture, and install the material handling system.  |                              | 100%           |
| • Cost of Machinery (i.e., cost to the seller of materials, fabrication labor by the seller, and the seller's overhead) is 55 percent to 70 percent of the Total Costs mentioned above. | 100% x 55%=55%               | 100% x 70%=70% |
| • Approximately 57 percent of the Cost of Machinery is directly related to Material Costs for the conveyor components.  | 55% x 57%=31% - rounded 30%  | 70% x 57%=40%  |
| • Engineering, design, fabrication labor, overhead, and installation represent the remaining costs.   | 100% - 31%=69% - rounded 70% | 100% - 40%=60% |